APPENDIX A — OPINION OF THE COURT OF APPEAL FOR THE FOURTH APPELLATE DISTRICT, DIVISION ONE, STATE OF CALIFORNIA FILED SEPTEMBER 22, 2000

COURT OF APPEAL, FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

D033521

(Super. Ct. No. 718299)

BITE, INC.,

Plaintiff and Appellant,

v.

FIRST NATIONAL BANK,

Defendant and Respondent.

APPEAL from a judgment of the Superior Court of San Diego County, John S. Meyer, Judge. Affirmed.

The issue here is which of two creditors has a superior interest in the proceeds of the debtor's contract with the federal government: an unpaid subcontractor, under equitable principles, or a lender with a perfected security interest under

Division 9 of the California Uniform Commercial Code.[1] The trial court found in favor of the secured creditor and granted it summary judgment on the subcontractor's conversion and related claims. We affirm.

FACTUAL AND PROCEDURAL BACKGROUND

Systems Exploration, Inc. (SEI) was a "technology contractor involved in several contracts with the U.S. Government." In 1984 First National Bank (Bank) extended SEI a $1.5 million line of credit in exchange for a security interest in SEI's government contracts and their proceeds, among other things. Bank filed UCC-1 financing statements perfecting its security interest. Subsequently, the military awarded SEI a contract (Prime Contract) for "the construction of IMIS or the Integrated Management Information System, . . . a software support and maintenance system for weapons systems of the U.S. Air Force worldwide." It is undisputed that Bank's security interest in SEI's assets extended to the Prime Contract and its proceeds. In September 1988 SEI subcontracted with BITE, Inc. (BITE) for its provision of analytical services and materials on the IMIS project. The government did not require SEI to obtain any Miller Act payment bond.[2]

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1. Statutory references are to the California Uniform Commercial Code unless otherwise specified. In 1999, the Legislature revised and reorganized Division 9 of that code, but the changes are not effective until 2001. All references to the California Uniform Commercial Code are to the existing version.

2. Because sovereign immunity precludes subcontractors and suppliers from filing liens against public property, Congress enacted

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Appendix A

SEI had financial difficulties during performance of the Prime Contract. In December 1991 Bank agreed to finance the purchase of SEI's assigned assets by a company named SYS. The assets remained subject to Bank's perfected security interest.

In March 1992 SEI and Bank entered into an agreement for "lock box" services. "[P]ursuant to this arrangement, all remittances to SEI and/or SYS under the assigned government contracts were made to a lock box [with Bank], deposited into a controlled account, and then applied against the credit line when the checks cleared."

SEI failed to pay BITE a balance of approximately $115,000 on the subcontract. BITE sought the assistance of the military's administrator of the Prime Contract, David P. Miller, in obtaining payment from contract funds in Bank's possession. Between 1993 and 1995 Miller unsuccessfully "sought concessions from [Bank], asking that [Bank] agree to allow the unpaid subcontractors under the Prime Contract to be paid ahead of [Bank]."

In January 1995 Bank approved of SYS's sale of its interest in SEI's assets to KRW Contracts and Financial Management, Inc. (KRW) in exchange for KRW's assumption of SYS's obligations to Bank. The contract stated Bank would "maintain a segregated SEI Subcontractor Account" for deposit of funds "identified by SYS as

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(Cont'd)
the Miller Act, requiring payment and performance bonds on specified federal construction projects. (*Department of Army v. Blue Fox, Inc.* (1999) 525 U.S. 255; 40 U.S.C. §§ 270a-270d.)

subcontractor funds. After full payment [of SYS's obligation to Bank], any amounts remaining in the SEI Subcontractor Account shall revert back to SYS for distribution[.]"

In February 1995 BITE discovered Bank had an account containing $255,000 in proceeds from SEI government contracts. BITE demanded payment from the account, but Bank refused to subordinate its security interest. In April 1995 Bank transferred its security interest in the SEI assets, including Prime Contract proceeds, to Big Canyon Investments, Inc. (Big Canyon). In February 1998 BITE sued Bank for conversion and related counts. BITE alleged it had a superior equitable lien on the Prime Contract proceeds and Bank wrongfully applied Prime Contract proceeds to its loan balances before the Big Canyon transfer. Bank successfully moved for summary judgment on the ground its perfected security interest was senior to BITE's unsecured claim. Judgment was entered on March 23, 1999.

DISCUSSION

I. *Standard of Review*

Summary judgment is proper only where there is no triable issue of material fact and the moving party is entitled to judgment as a matter of law. (Code Civ. Proc., § 437c, subd. (c).) "On review of a summary judgment in favor of the defendant, we review the record de novo to determine whether the defendant has conclusively negated a necessary element of the plaintiff's case or demonstrated that under no hypothesis is there a material issue of fact that requires the process of trial. [Citation.]" (*Ann M. v. Pacific Plaza Shopping Center* (1993) 6 Cal.4th 666, 673-674.)

Appendix A

II. *BITE's Theories of Recovery*

"It is the pleadings which delimit the scope of the issues on summary judgment." (*Couch v. San Juan United School Dist.* (1995) 33 Cal.App4th 1491, 1499.) BITE's complaint includes counts for conversion, constructive trust and resulting trust.

"Conversion is any act of dominion wrongfully exerted over another's personal property in denial of or inconsistent with his rights therein" (*Messerall v. Fulwider* (1988) 199 Cal.App.3d 1324, 1329.) "'A constructive trust is an equitable remedy to compel a person who has property to which he is not justly entitled to transfer it to the person entitled thereto. [Citations.]' [Citation.]" (*Farmers Ins. Exchange v. Zerin* (1997) 53 Cal.App.4th 445, 457.) "A resulting trust arises from a transfer of property under circumstances showing that the transferee was not intended to take the beneficial interest. [Citations.]" (11 Witkin, Summary of Cal. Law (9th ed. 1990) Trusts, § 297, pp. 1131-1132.) Bank, of course, cannot be liable under any of these theories if it enjoyed a superior security interest in the Prime Contract proceeds.

III. *Priority*

A

Personal property secured transactions are governed by Division 9 of the Commercial Code, California's version of the Uniform Commercial Code (UCC). (See generally Secured Transactions in California Commercial Law Practice (Cont.Ed.Bar 1986) §§ 1.1, 1.2, pp. 3-4 (Cont.Ed.Bar

hereinafter cited as CEB);[3] 3 Witkin, Summary of Cal. Law (9th ed. 1987) Secured Transactions in Personal Property, §§ 20-2 1, pp. 443-444.) Under the statutory scheme, a creditor may acquire a security interest in the debtor's personal property by obtaining written consent and giving value. (§§ 9203, 9110.) The creditor may "perfect" the security interest, and thereby protect it from the claims of third parties, by filing a UCC-1 financing statement or taking possession of the property. (See § 9303, subd. (1).) A Division 9 security interest, even if unperfected, prevails over the claim of a mere general creditor. (CEB § 4.2; §§ 9201, 9301, 9312, subds. (3)-(5).)

BITE concedes that Bank had a perfected security interest in the Prime Contract proceeds. BITE contends, however, that summary judgment was improper because as a materials and services supplier on the IMIS project it had a superior common law equitable lien on the funds.

The California Uniform Commercial Code contains a general instruction that, "[u]nless displaced by the particular provisions of this code, the principles of law and equity . . . shall supplement its provisions." (§ 1103.) "The purpose of . . . section [1103] is to allow the courts to fill gaps in the statute with recognized principles of law and equity. . . . In most cases, the courts are careful to use supplementary principles only as gap-fillers, not to 'displace' the rules of the UCC.'" (Clark, *The Law of*

3. "Divisions" of the California Uniform Commercial Code correspond to "Articles" of the UCC. (CEB, § 1.2.) UCC "section numbers are distinguished from those in the California version by the inclusion of a hyphen[.]" (*Ibid.*)

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Secured Transactions Under the Uniform Commercial Code (1993) ¶ 3.14, pp. 3-156 to 3-157; see also 4 White & Summers, Uniform Commercial Code (4th ed. 1995) Priority Conflicts, § 33-20, p. 377; Hillman et al., *Common Law and Equity Under the Uniform Commercial Code* (1985) ¶ 1.06[3][a], pp. 1-18 to 1-19.)

Bank contends that any equitable lien of subcontractors on the proceeds of government contracts has been "displaced," within the meaning of section 1103, by sections 9104 and 9310. Subdivision (c) of section 9104 provides that Division 9 is inapplicable "[t]o a lien given by statute or other rule of law for services or materials except as provided in Section 9310 on priority of such liens[.]" Section 9310 provides that the *possessory* lien of a services or materials supplier ordinarily takes priority over a perfected security interest.[4]

Bank asserts that since section 9310 addresses only possessory liens, it impliedly precludes nonpossessory liens from taking seniority over perfected security interests. It is generally recognized, however, that section 9-103 of the UCC is not amenable to that interpretation. "Section 9-310 [of the UCC] is a limited priority rule which is only applicable to disputes between possessory lienholders and secured creditors. Other state law should resolve priority disputes in

4. Section 9310 states: "When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise."

other contexts," including disputes between nonpossessory lien claimants and secured creditors. (4 White & Summers, *supra*, Scope of Article 9, § 30-12, pp. 93-94, fns. omitted.)

In *In re Brazier Forest Products, Inc.* (Wash. 1986) 724 P.2d 970, the court explained, "in accordance with the predominant authority, nonpossessory liens are outside the scope of [UCC] section 9-310 and therefore, their priority relative to a perfected security interest is governed by pre-Code statutory and common law." (*Id.* at p. 978.) The court held "this interpretation of [UCC] section 9-310 is more reasonable than inferring from the provision that all nonpossessory liens are subordinate to perfected security interests." (*Ibid.*, fn. omitted; see also *Oliver v. Bledsoe* (1992) 5 Cal.App4th 998, 1005.) Where equitable claims are not displaced by the UCC, they must be resolved in accordance with "judicial rulemaking based on applicable statutes, precedents, and principles and on the overarching policies and purposes of the code itself." (*Oliver v. Bledsoe, supra,* at p. 1005.)

B

According to one commentator, "[t]he most heavily litigated section in the entire UCC is § 1-103[.]" (Clark, *supra,* ¶ 3.14, p. 3-156.) In *Knox v. Phoenix Leasing, Inc.* (1994) 29 Cal.App.4th 1357, the court explained that section 1-103 of the UCC "has divided courts considering whether restitution can be had from a code-protected creditor. On the one hand, a decided majority of jurisdictions have disallowed the equitable remedy of restitution (whether termed unjust enrichment, quantum meruit, contract implied in law, etc.).

They are willing to accept occasionally harsh results as the price to be paid for preserving the integrity of the [UCC's] scheme for secured transactions, encouraging compliance with the code, and thereby ensuring a predictable system of creditor priorities. [Citations.] [5] On the other hand, California and . . . Colorado, while conceding considerable soundness to the majority position, have permitted restitution from a secured creditor." (*Id.* at pp. 1360-1361, fn. omitted, citing *Producers Cotton Oil Co. v. Amstar Corp.* (1988) 197 Cal.App.3d 638 (*Producers Cotton*); *Ninth Dist. Prod. Credit v. Ed Duggan* (*Colo.* 1991) 821 P.2d 788 (*Duggan*).)

In *Producers Cotton, supra,* 197 Cal.App.3d 638, Producers Cotton Oil Company (Producers) loaned Cecil Borboa more than $2 million in exchange for a security agreement covering his sugar beet crops and their proceeds. Borboa contracted to sell the 1981 crop to Amstar Corporation (Amstar), which was aware of Producer's security interest therein. Without obtaining a subordination agreement, Amstar deducted its harvest expenses and associated costs from the crop proceeds and remitted the

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5. For instance, in *Central Wash. Bank v. Mendelson-Zeller* (Wash. 1989) 779 P.2d 697, the Washington Supreme Court refused to create nonstatutory "equitable exceptions to the priority rules [because they] would hinder the purposes behind Article 9 — to simplify the law of secured transactions and create commercial certainty and reliance by creditors on Code provisions." (*Id.* at p. 705; see also *Peerless Packing Co. v. Malone & Hyde* (W.Va. 1988) 376 S.E.2d 161, 164-166, fn. 4 [only "virtually fraudulent conduct" would justify equitable claim for relief from UCC priorities in view of strong policy for adherence to the priority system].)

balance to Producers. Producers sued Amstar for conversion, alleging the deductions violated its security interest.

The court held that Amstar had a superior equitable interest in the crop proceeds under an unjust enrichment theory. "[W]hen a party possessing a security interest in a crop and its proceeds has knowledge of and acquiesces in expenditures made which are *necessary* to the development of the crop, and ultimately benefits from the expenditures, a party who, through mistake, pays such costs without first obtaining subordination, is entitled to recover." (*Producers Cotton, supra,* 197 Cal.App.3d at p. 660, original italics.)

In *Duggan, supra,* 821 P.2d 788, Ed Duggan, Inc. (Duggan) supplied feed grain to a livestock company whose accounts receivable were subject to a credit association's security interest. When the livestock company defaulted on its loan, cattle fed with Duggan's grain were sold and the credit association retained the proceeds. The Colorado Supreme Court determined Duggan could obtain restitution from the credit association notwithstanding its security interest. "In a situation where a secured creditor *initiates or encourages* transactions between the debtor and suppliers of goods or services, and benefits from the goods or services supplied to produce such debts, equitable principles require that the secured creditor compensate even an unsecured creditor to avoid being unjustly enriched." (*Id.* at p. 798, italics added.)

The *Duggan* court noted: "In *Producers Cotton* . . . the court held that the secured creditor's act of acquiescing in the harvesting of the secured collateral (crops) was a

sufficient basis for holding the secured creditor liable on the theory of unjust enrichment. However, in that case, the harvesting was necessary to the actual *preservation* of the secured collateral. . . . Here, the delivery of the corn was not essential to the secured collateral, but instead served to augment or enhance its value. In such a case, more than mere acquiescence is required to hold a secured creditor liable on the basis of unjust enrichment." (*Duggan, supra,* 821 P.2d at p. 797, fn. 17.)

In *Knox, supra,* 29 Cal.App4th 1357, Phoenix Leasing Incorporated (Phoenix) provided financing to Domaine Laurier Winery (Domaine) for the expansion of its plant. Phoenix obtained a security agreement covering Domaine's personal property, including after-acquired oak wine barrels Domaine ordered from Mel Knox. Phoenix paid Knox for the first shipment of barrels but declared Domaine in default on the loan before paying for the second shipment, and the barrels were included in the liquidation of Domaine's assets. Knox sued Phoenix for restitution under an unjust enrichment theory, and the court awarded him the resale value of the barrels.

The Court of Appeal reversed the judgment, explaining that although restitution claims against a secured creditor may be allowed in California under section 1103 in "a very limited class of cases" (*Knox, supra,* 29 Cal.App.4th at p. 1364), "simply pointing to benefit realized by the secured creditor will not suffice." (*Id.* at p. 1365.) The court held that a secured creditor's mere acquiescence is insufficient to upset Division 9 priorities, where the unsecured creditor's

provision of goods and services was useful but not essential to preserve the collateral. "The mere fact of augmenting or enhancing the collateral's value is by itself insufficiently notable to justify special equitable protection from article 9's priority structure. If allowed, this exception would swallow the rule." (*Id.* at pp. 1366-1367.)

Producers Cotton, Duggan and *Knox* do not concern the equitable lien claims of unsecured creditors, but such claims are also based on unjust enrichment. (4 Witkin, *supra,* § 173, p. 162.) "A promise to pay a debt out of a particular fund, without more, will not create an equitable lien on that fund." (*Farmers Ins. Exchange v. Zerin, supra,* 53 Cal.App.4th at p. 454.) "However, even a mere promise to pay from a specific fund may suffice to create an equitable lien if considerations of detrimental reliance or unjust enrichment are implicated." (*Id.* at p. 455.)

For instance, in *McBain v. Santa Clara Sav. & Loan Assn.* (1966) 241 Cal.App.2d 829, the court held "that, where suppliers of labor or materials have been induced to rely on the [construction] loan fund by either the *borrower or the lender,* their equitable liens on the fund should have priority over the claims of *both* of such last mentioned persons to the fund. Basically it is the fund itself and the arrangement for progress payments therefrom, created by the mutual agreement of the borrower and the lender, that constitutes the material inducement to the subcontractors and materialmen." (*Id.* at p. 841.) In *McBain,* the evidence established that the borrower specifically told the lien

claimants they would be paid for their services from the proceeds of the construction loan.[6] (*Id.* at p. 840.)

Based on the foregoing authorities, we conclude the court properly granted Bank's summary judgment motion. Bank met its burden of proving entitlement to judgment as a matter of law, based on its perfected security interest in the Prime Contract proceeds, and BITE raised no triable issue of material fact requiring trial. BITE made no showing that Bank initiated, encouraged or even acquiesced in transactions between BITE and SEI, or that during performance of the subcontract BITE had any expectation of payment from Prime Contract funds in Bank's possession. (See *Knox, supra,* 29 Cal.App.4th at p. 1367.)

Further, BITE made no showing that the materials and services it provided on the IMIS project were required to preserve the collateral, or that BITE's performance of the subcontract relieved Bank from the responsibility of having others perform the work. BITE simply produced no evidence suggesting Bank was unjustly enriched by retaining the Prime Contract proceeds.[7] Contrary to BITE's assertion, Bank's

6. In response to *McBain* and related cases, the Legislature enacted Civil Code section 3264, "eliminating altogether the supplier's equitable lien on construction loan accounts." *(Nibbi Brothers, Inc. v. Hoine Federal Sav. & Loan Assn.* (1988) 205 Cal.App.3d 1415, 1420; *Connolly Development, Inc. v. Superior Court* (1976) 17 Cal.3d 803, 827, fn. 25.)

7. BITE submitted the declaration of its president, John W. Cunningham, but he offered only conclusory statements regarding BITE's ostensible equitable lien against the Prime Contract (Cont'd)

mere refusal to subordinate its security interest does not evidence fraud, misrepresentation or bad faith.

C

BITE contends its superior equitable interest in the Prime Contract funds is established by federal cases concerning contests between banks and sureties on government construction projects requiring performance or payment bonds. (*Pearlman v. Reliance Ins. Co.* (1962) 371 U.S. 132; *Henningsen v. United States Fid. & Guar. Co.* (1908) 208 U.S. 404; *Prairie State Bank v. United States* (1896) 164 U.S. 227.) To any extent the cases are applicable in the nonsurety context, they are distinguishable on the basis of when the parties' security interests arose.

In *Prairie State,* the surety compelled to satisfy a performance bond and a lender both claimed equitable liens on the undisbursed balance on a federal construction contract. The United States Supreme Court held the surety was subrogated to the rights of the government to use the contract funds to complete the work in the absence of a performance bond, and "the rights of the parties depend upon whether" the surety's or lender's rights were first in time. (*Prairie State, supra,* 164 U.S. at p. 232.) The court concluded the surety's

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proceeds. Neither the unsigned declaration of Miller — the military's administrator of the Prime Contract — nor the unsigned agreement between him and SEI requiring SEI to deposit proceeds into a control account with Bank for the benefit of SEI's creditors is competent evidence. In any event, any agreement exclusively between SEI and Miller would not establish BITE's detrimental reliance or Bank's unjust enrichment.

interest was superior because it arose upon execution of the bond, which was before the contractor's assignment of the contract proceeds to the lender. (*Id.* at pp. 232, 239.) The same scenario was present in *Henningsen* in the context of the surety's satisfaction of a payment bond. (*Henningsen, supra,* 208 U.S. at pp. 405-406.) In *Pearlman,* the Court held that a surety's equitable interest in the proceeds of a construction contract were superior to those of a bankruptcy trustee. The surety's interest arose when the prime contract was executed, before bankruptcy proceedings were commenced. (*Pearlman, supra,* 371 U.S. at pp. 133-134.)

As the court noted in *Maryland Casualty Co. v. Dulaney Lumber Co.* (1928) 23 F.2d 378, "[w]here performance of the contract results in a loss, it is the settled general rule in the federal courts that the right of a surety under its bond to the retained percentage is superior to the right of a bank, which advances money under an assignment from the contractor *taken subsequently,* or without notice to the surety." (*Id.* at p. 380, italics added, citing *Prairie State, supra,* 164 U.S. 227 and *Henningsen, supra,* 208 U.S. 404; see also *First Alabama Bank of Birmingham v. Hartford Accident & Indemnity Co., Inc.* (N.D. Ala. 1977) 430 F.Supp. 907, 910 [priorities between secured lender and surety subrogated to equitable interests of subcontractors dependent upon time respective rights arose].)

"A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. . . . If such steps are taken before the security interest attaches, it is perfected at the time when it attaches." (§ 9303, subd. (1).) Bank's security interest in the Prime

Contract was perfected when SEI entered into it and obtained rights thereunder, since Bank had previously filed a financing statement giving notice of SEI's after-acquired government contracts and related accounts receivable. (See *Biggins v. Southwest Bank* (9th Cir. 1974) 490 F.2d 1304, 1309-1310; *First Alabama Bank of Birmingham v. Hartford Accident & Indemnity Co., Inc., supra,* 430 F.Supp. at pp. 910-911.) The subcontract between BITE and SEI was entered into after Bank's security interest in the Prime Contract was perfected, and thus Bank's rights were superior as previous in time.

BITE's reliance on *Department of Army v. Blue Fox, Inc., supra,* 525 U.S. 255, is also unavailing. There, a subcontractor on an Army construction project without a Miller Act payment bond sought to impress an equitable lien on undisbursed contract funds held by the government. The court confirmed that "unless waived by Congress, sovereign immunity bars subcontractors and other creditors from enforcing liens on Government property or funds to recoup their losses." (*Id.* at p. 265.) *Blue Fox* does not stand for the proposition that subcontractors on government projects have the unequivocal right to be paid ahead of secured creditors.

Appendix A

DISPOSITION

The judgment is affirmed. Bank is awarded costs on appeal.

s/ Nares
NARES, J.

WE CONCUR:

s/ Kremer
KREMER, P.J.

s/ McDonald
McDONALD, J.

APPENDIX B — FINAL JUDGMENT OF THE SUPERIOR COURT FOR THE STATE OF CALIFORNIA FOR THE COUNTY OF SAN DIEGO DATED AND FILED MARCH 23, 1999

SUPERIOR COURT FOR THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN DIEGO

Case No. 718299

IC Judge: John S. Meyer
Dept: 61

BITE, INC., a Virginia corporation,

Plaintiff,

-vs-

FIRST NATIONAL BANK, a California corporation; and DOES 51 through 100, inclusive,

Defendants.

FINAL JUDGMENT BY COURT PURSUANT TO CODE CIV. PROC. § 437c

The above Court, having entered its Order Granting the Motion of Defendant FIRST NATIONAL BANK for Summary Judgment against Plaintiff BITE, INC. by way of a Ruling on Submitted Matter dated March 2, 1999, which adopted the Court's tentative ruling of February 19, 1999.

Appendix B

HEREBY ORDERS, ADJUDGES AND DECREES that Plaintiff BITE, INC. shall recover nothing from Defendant FIRST NATIONAL BANK. Defendant FIRST NATIONAL BANK is awarded its costs pursuant to a memorandum of costs to be filed. *Costs awarded in the sum of $662.35 (JRM 4/21/99)*

IT IS ORDERED.
Dated MAR 23 1999

s/ John S. Meyer
Judge of the Superior Court

APPROVED AS TO FORM:
Dated March 16, 1999

s/ Robert L. Rentto
Robert L. Rentto
Attorney for BITE, INC.

APPENDIX C — OPINION OF THE SUPREME COURT OF CALIFORNIA DENYING PETITION FOR REVIEW FILED DECEMBER 13, 2000

Court of Appeal, Fourth Appellate District,
Division One - No. D033521
S092649

IN THE SUPREME COURT OF CALIFORNIA

En Banc

BITE INC., Plaintiff and Appellant,

v.

FIRST NATIONAL BANK, Defendant and Respondent.

Petition for review DENIED.

s/ George
Chief Justice